June & July 2024 Market Insights

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The Elephant (and Donkey) in the room -- three risks and three opportunities for the second half of 2024

We are nearly half way through 2024 and several noteworthy developments have taken place since the beginning of the year: an economic soft landing has become consensus, expectations for Fed rate cuts have diminished significantly, AI enthusiasm remains robust, inflation appeared sticky but has recently shifted downward, credit conditions have not gotten overly restrictive despite "higher for longer" interest rates, and, with all of this in the mix, the S&P 500 is up double-digits so far on the year. We believe the current economic environment remains healthy and the market backdrop remains favorable for risk-taking. In the spirit of maintaining vigilance, however, we first highlight three risks that could derail the economy and/or markets and then discuss three potential opportunities that could enhance second half economic and market strength.

Three risks lying in plain sight

Risk 1: Credit markets become less friendly as commercial real estate (CRE) strains become more acute. While the strains in CRE are well-known, they are also slow moving and in illiquid markets with long refinancing cycles. These characteristics make the impact both drawn out and difficult to assess. Credit conditions have indeed tightened following the Fed's rate hike campaign, but credit is still flowing and has been an important support for the economy and markets. Credit spreads ***(Exhibit #1)*** are a leading indicator that we continue to monitor for changes in character to credit markets.

Risk 2: The bite of high interest rates could have a delayed but significant impact on the economy. We certainly see pockets where higher interest rates have led to moderation such as housing demand, business spending, and auto sales. Greater strains are being felt by consumers on the lower portion of the socio-economic spectrum as well as by smaller companies with less access to capital. We believe the collective impact of these strains is insufficient to derail the economy or markets, but we continue to monitor leading indicators such as surveys of business future capital expenditures and weekly initial unemployment claims.

Risk 3: Certain election outcomes could drive up longer-term interest rates or reignite inflationary pressures. While election outcomes – both presidential and congressional control – remain highly uncertain, post-election policies that result in greater spending or aggressive and widespread tariffs have the potential to push inflation and interest rates higher. Tax policy is also a relevant consideration, although significant changes to tax policy would likely require either a red wave or blue wave to pass through Congress. With the election over four months away, uncertainty reigns. As we move into the fall season, it is possible that the markets take a more cautious approach and wait to see what combination of elections results and subsequent expected policy moves prevails.

Exhibit 1: Bloomberg Corporate High Yield Debt - Credit Spread

Source: Bloomberg L.P. (2024), BMO Wealth Management (2024); As of 06/12/2024

Three opportunities that could strengthen the economy and drive markets higher

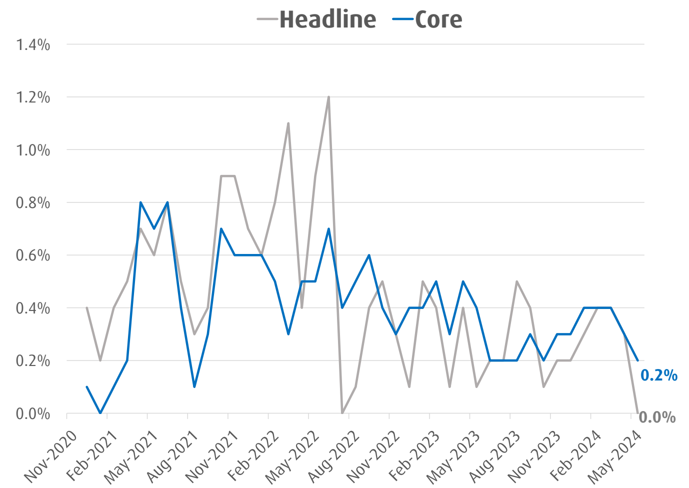
Opportunity 1: Productivity gains from AI become more tangible as companies turn "use cases" into implementation. A multi-year improvement in productivity – similar to what the economy experienced in the mid-1990s – could be a "silver bullet" that accelerates growth, moderates inflation, and still allows for healthy wage gains. We believe these favorable productivity gains will happen to some degree, but both the extent and timing remain uncertain.

Opportunity 2: Inflation falls faster than currently expected and allows the Fed to cut interest rates once or even twice by year end. The May CPI report showed an attention-grabbing zero for headline inflation on a month-over-month basis ***(Exhibit #2)***. Our base case continues to be inflation moderating gradually in the second half of 2024 and for the Fed to cut interest rates once by year end. Rather than "moderating gradually," however, a swifter decline in inflation through year end is no longer far-fetched.

Opportunity 3: Elements are in place for a possible acceleration of spending by businesses. The first element is that businesses are emerging from a period of relative caution amid what was a steady "impending recession" drumbeat. As companies now turn to growth mode, spending is likely to pick up to support that growth. Another element pointing in the same direction is that corporate profitability has picked up and is expected to continue rising through year end. Rising profits typically leads to increased spending. Business spending may be only a fraction of consumer spending (which we also believe will remain steady), but it varies considerably more and often plays an important role in overall economic growth.

In assessing our investment positioning, the rub is that a mix of both risks and opportunities – not overwhelmingly one or the other – is what typically plays out. The magnitudes, impacts, and even interplay of these factors becomes crucial. Our positive outlook for equity markets in the second half of 2024 is predicated on these and other ongoing assessments which currently tilt toward opportunities outweighing risks.

Exhibit 2: U.S. Consumer Price Index (MoM %)



Source: Bureau of Labor Statistics (2024), Bloomberg L.P. (2024), BMO Wealth Management (2024); As of 05/31/2024

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